

DOCKET SECTION

BEFORE THE  
POSTAL RATE COMMISSION  
WASHINGTON, D.C. 20268-0001

Postal Rate and Fee Changes, 1997

Docket No. R97-1

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INITIAL BRIEF OF THE  
NEWSPAPER ASSOCIATION OF AMERICA

April 1, 1998

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**INITIAL BRIEF OF THE  
NEWSPAPER ASSOCIATION OF AMERICA  
April 1, 1998**

The Newspaper Association of America ("NAA"), by its attorneys, hereby respectfully submits its initial brief in this proceeding.<sup>1</sup>

**I. INTRODUCTION AND SUMMARY**

**A. Overview**

In the Postal Reorganization Act of 1970, Congress required the United States Postal Service to provide universal service at reasonable and nondiscriminatory rates. As NAA's Trial Brief discusses more fully, in recent years NAA member newspapers have seen the Postal Service move farther and farther away from its fundamental public service mission. NAA believes that the Postal Service is now more concerned with gaining market share in "competitive markets" through leveraging its monopoly than with serving the American public.

The USPS has become more and more a competitor to newspapers than a competitively neutral public service, as it consciously seeks to shift advertising dollars

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<sup>1</sup> Pursuant to the Presiding Officer's rulings at Tr. 1/26-29 and in Ruling No. R97-1/4, the Trial Brief of the Newspaper Association of America (February 10, 1998) and NAA's Memorandum of Law on the Pound Rate for Standard (A) Enhanced Carrier Route Mail (March 26, 1998) are integral parts of this brief.

away from newspapers and into direct mail.<sup>2</sup> This “taking of sides” is not appropriate behavior for an agency of the federal government, is not what Congress intended in the Postal Reorganization Act of 1970, and should stop.<sup>3</sup>

This trend continues in this case. The Postal Service, while asking for an overall revenue increase of about \$2.5 billion, singles out pound-rated Standard (A) flat mail for a *decrease*. Moreover, it once again would spare “competitive” services from having to make a reasonable contribution to institutional costs, and instead would saddle First Class mailers with an overwhelming share of the institutional costs of the system. Indeed, under the rates proposed by the USPS in this proceeding, **every** piece of Standard (A) Enhanced Carrier Route saturation mail weighing less than 15 ounces would pay less postage than a two-ounce First Class letter.<sup>4</sup>

This case presents the Commission with an opportunity to recommend postal rates that promote the Postal Service’s mission as a public service consistent with its governmental status and duty to provide service on a nondiscriminatory basis. The most important steps in this direction that the Commission can take in this case are

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<sup>2</sup> The Postal Service’s 1998 Marketing Plan leaves no doubt that this is the case. See NAA/R97-1 LR 2 at AD Page 40, where listed as an objective is the USPS’s goal “Ultimately to establish “day certain” delivery for selected categories of Ad Mail, and create the platform for moving substantial revenues from pre-printed newspaper inserts to mail.” See *also* AD Page 1 through AD Page 57.

<sup>3</sup> The Postal Service has sought to pull substantial advertising dollars out of newspapers despite the fact that newspapers are very good customers of the USPS and make *substantial* use of First Class, Periodicals, and Standard (A) mail.

<sup>4</sup> A two ounce First Class letter would pay 56 cents (33¢ + 23¢); a 15 ounce saturation piece would pay 52.9¢ (15/16 x 53¢ + 3.2¢). A 15 ounce saturation flat entered at the destination delivery office would pay merely 42.5¢.

(1) to reject the USPS's proposed reduction in the Standard (A) pound rate and (2) to revamp its assignment of institutional costs to relieve the excessive burden now borne by First Class mail, taking into greater account the mix of postal functions used by the subclasses of mail and the unit contributions per piece.

## **B. Specific Recommendations**

In its Trial Brief and its Memorandum of Law on the ECR Pound Rate, NAA presented a discussion of the policy issues relevant to the provision of this "basic and fundamental service" and a specific detailed discussion of what NAA regards as the single most important issue in this case – the Postal Service's proposed reduction of the ECR pound rate. Consistent with these prior filings, NAA submits that the Commission should:

- Reject the proposed pound rate reduction in ECR Standard (A) Mail and continue to set the pound rate in the manner used in Docket No. MC95-1;
- Explicitly announce that institutional cost assignments will no longer be used as a means of promoting the "competitive" interest of the Postal Service by burdening First Class ratepayers;
- Assign institutional costs on a weighted attributable cost basis as proposed by NAA witness Chown to reflect the fact that, in today's highly discounted rate environment, the base of attributable costs traditionally used in setting contributions no longer serves as a fair starting point for judging appropriate contributions;
- Adjust the relative institutional cost burdens to begin relieving First Class mailers of their unfair and undue burden by, in particular:
  - Adopting the proposal of ABA/NAA witness Clifton to reduce the extra ounce charge for First Class workshared mail to 12 cents for the first and second extra ounces and recover the lost revenue from Standard (A) mail;
  - Placing a greater emphasis on unit cost contributions; and



- Shifting additional costs to Standard (A) mail to bring the unit cost contributions made by First Class and Standard (A) mail closer together, such as through the adoption of ABA/EEI/NAPM witness Clifton's proposals to reduce the cost coverage for workshared First Class mail;
- Reject the Postal Service's proposal to increase presortation discounts in ECR mail for the reasons stated by NAA witness Donlan;
- Reject the proposal of AMMA witness Andrew to increase the proposed destination entry discounts in Standard (A) commercial mail;
- Accommodate the Postal Service's automation program by not recognizing a letter/flat rate differential at the basic tier of the Standard (A) Enhanced Carrier Route subclass, but recognize the cost differences between letters and flats at the high density and saturation tiers;
- Continue to attribute city carrier Cost Segment 7 access and coverage-related load costs using the single subclass stop methodology;
- Reject the Postal Service's proposal sponsored by witness Bradley to reduce cost attribution in mail processing;
- Adopt USPS witness Nelson's proposed attribution of park and loop costs;
- Adopt USPS witness Wade's proposed attribution of vehicle service driver costs;
- Reaffirm its consistent ruling that institutional costs should be marked up from a base consisting of all attributable costs, not merely volume variable costs; and
- Continue to reject Ramsey pricing as inappropriate under the Postal Reorganization Act.

These issues are addressed in detail in the sections that follow.

**II. THE COMMISSION SHOULD REJECT THE POSTAL SERVICE'S PROPOSED REDUCTION IN THE STANDARD (A) ENHANCED CARRIER ROUTE MAIL POUND RATE AND RETAIN ITS CURRENT METHOD OF DETERMINING THE POUND RATE**

As explained in NAA's Trial Brief and March 26 Memorandum of Law on the pound rate, the Commission should reject the USPS's proposal to lower the Standard (A) mail pound rate. Instead, the Commission should continue to determine that rate using the cost-based formula that it has employed since Docket No. R90-1.

Most importantly, the USPS has failed to provide sufficient evidentiary basis for its proposal.<sup>5</sup> The cost analysis on which it purports to rely is not the comprehensive analysis of Standard mail costs which the Commission has long desired and is not sufficient evidence to justify lowering the pound rate. Rather, it is a cost allocation exercise which depends upon an excessive thinness of tallies in the very weight ranges affected by the proposal, and turns upon the per piece nature of several of its underlying assumptions.

Nor has the USPS justified the gaping disparity between its rate proposals for Standard (A) mail and First Class mail, which has a similar – but much higher priced – rate schedule for heavier mail, and one which the USPS proposes to steepen still more by eliminating the “heavy-weight discount” from First Class mail. Finally, the Postal Service has not even attempted to provide a satisfactory explanation of why it has singled out Standard (A) flat mail alone for a reduction, while raising First Class mail rates by a billion dollars.

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<sup>5</sup> NAA will not repeat here in detail the discussion from its March 26 memorandum concerning the serious flaws that beset the Postal Service's proposed lowering of the pound rate.

### III. INSTITUTIONAL COSTS: THE COMMISSION MUST REVISIT AND REVISE ITS METHOD OF ASSIGNING INSTITUTIONAL COSTS

The time has come to begin the process of bringing the institutional cost assignments of the postal system more into accord with the public service mission of the Postal Service by reducing First Class mail's institutional cost burden. At the outset, it is important to note that the assignment of institutional or "common" costs ultimately is a *policy* decision and not one dictated by economic theory. The assignment of institutional costs can be judged only by reference to the public policy result it produces. *The ultimate reference point is whether the assignment promotes the public service mission of the Postal Service as defined by Congress.* It is the task of the Postal Rate Commission to ensure that cost allocations and the resulting postal rates promote and do not impede that mission.

NAA does not believe that the institutional cost allocations and rates have properly reflected the policies of the 1970 Act for some years. In recent cases, the institutional cost allocations and rates have moved the Postal Service ever farther away from its public service mission while helping to maintain lower rates for "competitive" services. In seeking to increase volume first and foremost, the USPS has generally sought to expand institutional costs and to load them disproportionately onto First Class mail. The Commission should make clear that institutional cost assignments will no longer be used as a means of promoting the "competitive" ambitions of the Postal Service by burdening First Class mailers.

It is important, moreover, that the Commission's approach to setting institutional costs keep pace with overall changes in postal operations and the postal system. Indeed, the Commission has a legal duty to reconsider its methodology of assigning

institutional costs when circumstances change. See *California v. Federal Communications Commission*, 905 F.2d 1217 (9<sup>th</sup> Cir. 1990); *Greater Boston Television Corp. v. Federal Communications Commission*, 334 F.2d 552 (D.C. Cir. 1964).

Despite massive changes in postal operations over the years, the Commission's method of setting institutional cost contributions has not changed materially since 1970. This method is now outdated, and the Commission has a legal duty to revisit it.

**A. The Growth Of Worksharing Means That The Traditional Approach Of Assessing Relative Institutional Cost Assignments Is Now Out Of Date**

Since Reorganization, the principal measure of institutional cost assignments under 39 U.S.C. § 3622(b)(3) has been a comparison of a subclass's revenues to its total attributable costs – a concept referred to as cost coverage.<sup>6</sup> NAA submits that while this method might have been a useful way to assess institutional cost contributions in the era before the widespread use of barcoding and other worksharing discounts, it is outmoded in today's postal world and now inadvertently skews institutional cost contributions.

The current overall markup and cost coverages approach originated in an era when the rate schedules contained few if any discounts. See USPS-T-30 at 8 (O'Hara); Tr. 25/13438 (Chown). Postal rates at that time could be thought of as offering "end-to-end" service for each class. Since then, however, the enormous growth

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<sup>6</sup> The percentage by which rates exceed attributable costs is known as a "markup"; the ratio of a subclass's revenues to its costs is known as a cost coverage; and the "markup" of a subclass relative to the systemwide average is called the "markup index."

of worksharing discounts has resulted in the different subclasses using the Postal Service in different ways.<sup>7</sup> This in turn has resulted in different subclasses using different mixes of the Postal Service's *operational functions*. For instance, some subclasses make substantial use of mail processing and transportation while others do not. Thus, in today's system, costs and rates do not inherently reflect "end-to-end" service, nor end-to-end use of the Postal Service's operational functions.

In addition, it is important to recognize that the proportion of costs within each function that are attributed varies widely among functions. So not only do the subclasses make different use of postal functions, but those functions themselves are attributed in different proportions.<sup>8</sup>

Consequently, while the mixes of attributable costs were once more or less homogeneous across subclasses, that is no longer the case. Therefore, the comparison implicit in using the "end-to-end" attributable costs of the subclasses as a base for assigning institutional costs has changed.

Unfortunately, the "end-to-end" method for assigning institutional costs has not changed accordingly. As a consequence, NAA believes that the traditional comparison of attributable costs no longer provides a fair starting point for judging appropriate

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<sup>7</sup> Thus, worksharing mailers in a sense "cherry pick" the system, while leaving it for others to pick up the common costs.

<sup>8</sup> The mix of attributable costs across the different subclasses differs since each subclass use postal functions differently. See Tr. 25/13267 (Chown, Table 1). Not only are these costs distributed unevenly among the postal functions, but the subclasses make far different use of these functions. Tr. 25/13268 (Chown, Table 2).

contributions to common costs, a fact that should be reflected in the way that the Commission assigns institutional costs.<sup>9</sup>

The Commission is already aware that the current approach does not work well when applied to discounted workshared subclasses. Under today's system, a subclass that reduces its attributable costs in one function by worksharing (e.g., reducing its mail processing attributable costs by presorting) but retains the same cost coverage receives a reduced assignment of **all** institutional costs, not merely those identified with the mail processing function.<sup>10</sup> This in turn unfairly requires other mail to bear more institutional costs. Indeed, in Docket No. MC95-1, the Commission stated that, in such a situation: "There is no justification for raising the rate for [the nonworkshared] pieces, which have done nothing to increase Postal Service costs." *MC95-1 Op.* at III-28, ¶ 3072.

Thus, under the traditional approach, subclasses that primarily use mail functions for which relatively few costs are attributed make a relatively small (in dollars) contribution to institutional costs, even though they may make great use of functions

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<sup>9</sup> As Ms. Chown explains, "Applying a markup to total attributable costs is appropriate *only if* (1) all mailers buy approximately the same mix of the four basic functions *or* (2) the ratio of institutional costs to attributable costs is relatively constant across all four functions." Tr. 25/13265. Neither necessary assumption is true in today's postal system. *Accord* Tr. 25 /13377 (Chown).

<sup>10</sup> Although institutional costs are not *causally related* to any particular subclass, many of these costs indisputably arise from the provision of a particular function of the Postal Service. Currently, however, the Postal Service applies a markup or cost coverage to total subclass costs without regard to the mix of postal functions actually used by those subclasses.

which contain substantial institutional costs.<sup>11</sup> This is inequitable, was not anticipated when the current approach was first adopted, and should be changed.

Conversely, where a subclass reduces its attributable costs by worksharing but its institutional cost contribution (in absolute dollars) remains constant, the subclass's markup, when expressed as a percentage, automatically increases and gives the appearance that the subclass's institutional cost contribution has increased. See USPS-T-30 at 8-9 (O'Hara); *accord* Tr. 36/19704 (Andrew) (calling this an "arithmetic" phenomenon). Mailers in these highly discounted subclasses then argue that this new automatic or arithmetically increased cost coverage is inappropriately high.<sup>12</sup>

These examples show how the traditional method encounters problems in today's operational environment. Accordingly, the Commission should -- indeed must -- revisit its approach.

#### **B. The Traditional Method Of Assigning Institutional Costs Systematically Places An Excessive Institutional Cost Burden On First Class Mail**

The greatest flaw of the current institutional cost assignment methodology is that, in practice, it has a bias in favor of heavily workshared subclasses and against First

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<sup>11</sup> Conversely, subclasses that make greater use of postal functions with relatively high attributable costs are assigned a greater share of institutional cost, even though these same functions cause the Postal Service to incur a relatively low amount of institutional cost.

<sup>12</sup> This is a notion that the Commission recently considered and properly rejected in Docket No. MC95-1. In that decision, the Commission noted that a subclass's avoidance of attributable costs due to worksharing should not allow it to avoid institutional costs. Indeed, the Commission found this result to be "just," noting that the "unit cost contribution paid by each piece remains the same." See *Opinion and Recommended Decision*, Docket No. MC95-1 at III-28-29, ¶¶ 3071-73 ("MC95-1 Op.").

Class mail. As a consequence, it systematically places on First Class mail an excessive and disproportionate institutional cost burden. This misallocation of institutional costs harms the very mailers the postal monopoly is supposed to protect and also has competitive consequences not intended by Congress.

First Class rates currently recover a share of institutional costs of the system that greatly exceeds First Class mail's proportion of the total volume, the total attributable costs, and the total weight of the mailstream. First Class mail makes a disproportionate contribution whether stated in terms of (1) absolute dollars, (2) relative percentage of revenues compared to percentages of volume or weight, or (3) unit (per-piece) contributions in cents per piece.<sup>13</sup> In contrast, advertising mail generally, and ECR mail in particular, accounts for a substantially smaller share of both revenue and institutional cost contributions than its proportion of volume or weight would imply.

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<sup>13</sup> The testimony of Dr. James A. Clifton, co-sponsored by the American Bankers Association and NAA (ABA/NAA-T-1), discusses this fact. The same phenomenon receives attention in the testimony of Dr. Clifton's companion testimony on behalf of ABA/EEI/NAPM, and Major Mailers Association witness Richard Bentley. Similarly, the testimony of AAPS witness Kenneth Bradstreet discusses this pricing behavior from the perspective of a competitor.

The huge disparity cannot be justified on the ground that First Class mail incurs greater costs for forwarding, etc. Such cost differences between the two mail subclasses are already reflected in the attributed costs. Tr. 36/19765-67 (Andrew). Their grossly disproportionate institutional cost burdens can only be justified on the basis of non-cost criteria, and such criteria simply cannot explain the current vast differences.



A comparison of First Class and Standard (A) volumes and contributions makes the point:

	<u>% Total Volume</u>	<u>% Total Weight</u>	<u>% Total Revenues</u>	<u>% Inst. Costs</u>
First Class	49	17	55	61
Standard (A)	34	69	20	21

Tr. 21/11159 (Bentley, Figure 1). Likewise, as Dr. Clifton demonstrates, the unit cost contributions of First Class and Standard (A) mail are widely disparate, with workshared First Class letters making more than *twice* the unit cost contribution of Standard mail even though these groups of mail receive similar handling and processing:

<u>Mail Type</u>	<u>Unit Cost Contributions (¢/piece)</u>
Workshared First Class	18.04
Standard A Class	7.91
Regular	7.52
ECR	8.43

Tr. 21/10824; Exhibit USPS-30B, revised 9/19/97.<sup>14</sup> This gap between unit contributions has increased steadily since 1984, in part because of the continued use of an unweighted approach in determining institutional cost assignments:

	First Class Letters	Third Class Regular Rate	Difference
R84-1	8.79	3.32	5.47
R87-1	10.07	3.81	6.25
R90-1	12.12	5.29	6.84
R94-1	14.74	5.95	8.79
Proposed R97-1	17.55	7.91	9.64

<sup>14</sup> Under the Postal Service's proposed rates, overall First Class mail would make an average unit contribution per piece of 17.55 cents. Tr. 2/190 (O'Hara).

This gap should be reduced.

The Commission has repeatedly stated that it wants to bring the contributions of First Class Mail and advertising mail closer together.<sup>15</sup> In Docket No. R90-1, the Commission found that "we do not consider it to be consistent with the Act to shift an excessive proportion of the institutional cost burden onto First-Class (or any other) mailers."<sup>16</sup>

However, while troubled by these phenomena, the Commission has not directly corrected them. In both Docket Nos. R87-1 and R90-1, the Commission stated that it would have preferred to obtain a larger relative institutional cost contribution from third class mail but was restrained by its desire to avoid possible rate shock. *R90-1 Op.* at IV-31-32, ¶¶ 4102-03. That constraint does not exist in this case. The relatively small revenue requirement increase in this case presents the Commission with an opportunity to begin to move the institutional cost burden off of First Class mail and on to other classes.

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<sup>15</sup> Mr. Bentley's testimony contains an illuminating review of the Commission's past statements in this regard. See Tr. 21/11158.

<sup>16</sup> *Opinion and Recommended Decision*, Docket No. R90-1 at IV-34, ¶¶ 4107 ("R90-1 Op."); see also *Opinion and Recommended Decision*, Docket No. R94-1 at IV-15, ¶¶ 4040-41 ("R94-1 Op."); *Opinion and Recommended Decision*, Docket No. R87-1 at 367, ¶ 4026 ("R87-1 Op.").

**IV. THE COMMISSION SHOULD REVISE INSTITUTIONAL COST ASSIGNMENTS BY ADOPTING THE CHOWN PROPOSAL, GIVING GREATER WEIGHT TO UNIT INSTITUTIONAL COST CONTRIBUTIONS, AND ADOPTING THE PROPOSALS OF DR. CLIFTON**

NAA proposes that the Commission revise its assignment of institutional costs in this case in the following respects:

- First, the Commission should place far greater weight on:
  - (1) the relative mixes of postal functions used by the different classes and subclasses of mail in the manner proposed by NAA witness Sharon Chown; and
  - (2) the relative unit contributions to institutional costs (especially between similar subclasses) than it has in recent cases.
- Second, the Commission should begin to relieve the institutional cost burden of First Class mail by assigning more of the common costs to Standard (A) mail in the manner proposed by witness Clifton.

**A. The Commission Should Refine Its Method Of Assigning Institutional Costs In Recognition Of The Great Expansion Of Worksharing Since 1970 By Using Witness Chown's Weighted Attributable Cost Proposal**

NAA witness Chown proposes to refine the current method of assigning institutional costs by expressly considering the mix of postal functions used by each subclass. In particular, she proposes to weight the attributable costs of a subclass to reflect the relative mix of postal functions – mail processing, transportation, delivery, and window service – used by that subclass. This would give the Commission a fair starting point to judge relative institutional cost contributions in a way that reflects the different ways that subclasses benefit from institutional effort, and the different ways that the mailstream has evolved over the last three decades.

In particular, Ms. Chown proposes to weight the attributable cost of each postal function by a factor equal to that function's percentage of total institutional cost divided

by its percentage of total attributable cost.<sup>17</sup> The Commission would use a subclass's resulting "weighted attributable cost" -- instead of the unweighted attributable costs now used -- as the basis on which to determine judgmentally (in the same manner as now) the institutional cost contribution to be collected from the subclass. The resulting dollar contribution would then be added to the traditional attributable cost base (as is done today) to arrive at the subclass's target revenue.<sup>18</sup>

This would differ from the current approach only in one respect: institutional cost contributions would be evaluated using a weighted attributable cost basis rather than upon the unweighted attributable cost basis now used.<sup>19</sup> This provides the Commission with a sound measure of how the different subclasses benefit from institutional effort and identifiable institutional costs. To illustrate this analysis, Ms. Chown's testimony presents the mix of services used by the different subclasses of mail, and shows the implicit cost coverages when the Postal Service's proposed institutional contributions are evaluated on the basis of weighted attributable costs.

NAA believes that this refinement would help correct the problems inherent in the current, but outmoded, method. The Commission should use this metric in determining

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<sup>17</sup> The weighting formula appears in the record at Tr. 25/13320-22 (Chown).

<sup>18</sup> This weighting would be used only in assigning institutional costs; it would not affect the projected attributable costs of a subclass.

<sup>19</sup> Ms. Chown's method would not change the dollar amount of costs attributed to a subclass. Instead, it simply recognizes that each dollar of attributable costs should not be given the same weight when assigning institutional costs

appropriate institutional cost assignments for the commercial (non-Revenue Foregone) subclasses.<sup>20</sup>

**1. Weighted attributable costs provide a better and useful basis for assigning cost contributions in today's postal system**

The essential point of Ms. Chown's proposal is that the different subclasses of mail use the Postal Service differently, and that the Commission should consider, in assigning institutional costs, the relative mix of postal functions used by the different subclasses. Her "weighted attributable cost" basis inherently provides the Commission *with this information and with a better basis upon which it can exercise its judgment.*

In rebuttal, several witnesses criticized the Chown proposal on various grounds and have charged that weighted attributable costs are less useful than marginal costs. These criticisms are misplaced.

The rebuttal witnesses erroneously ignore that a large portion of institutional costs are associated with particular functions, and that Ms. Chown's proposal is more *informative in this respect than the traditional approach.* These witnesses err in assuming that the different subclasses do not make different use of the postal system. Therefore, they conclude wrongly that those different uses should not be reflected in the institutional cost assignment process.

These proponents of the *status quo* also have tried to confuse this issue by pointing out that institutional costs cannot be associated with any particular *service.* See Tr. 34/18232 & Tr. 34/18249 (Christensen); Tr. 34/18515 (Taufique); Tr. 34/18350

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<sup>20</sup> Ms. Chown did not propose a specific assignment of institutional costs.

(Crowder). That is obvious. If an institutional cost could be associated with any particular *subclass* of service, it would be attributed. NAA's point is that a large portion of institutional costs are directly associated with the provision of the different *functions* offered by the Postal Service and should be paid for by the subclasses that use those *functions* in a way that appropriately *reflects* that usage.

In a slightly different vein, MOAA, *et al.* witness Andrew does not dispute that some institutional costs are associated with the different functions provided by the Postal Service, but claims that this relationship is irrelevant since the Postal Service does not sell functions. Tr. 16/19675. NAA disagrees. Through the provision of presort and dropship discounts, the Postal Service essentially gives many mailers the choice of buying mail processing and/or transportation from either the Postal Service or a private alternative.

Importantly, Postal Service witness Taufique agreed on cross-examination that those who do not use a function should not be burdened with the overhead costs associated with providing the function.<sup>21</sup> And, indeed, this is the very point of Ms. Chown's proposal -- to help ensure that the rates for mailers who use a function recover the institutional costs associated with the function.

In a different criticism, witness Andrew testifies that the Chown proposal is "unstable" on the grounds that it is sensitive to changes in attributable costs and

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<sup>21</sup> When witness Taufique was asked whether the cost of an espresso machine should be recovered from customers drinking espresso and cappuccino (the two services which used the machine) or from customers drinking coffee, he stated that the machine was related to the production of espresso and cappuccino and should be recovered from these customers. Tr. 34/18527-8 ( "The price of coffee would not recover the cost [of the machine]").

identifiable institutional costs. On the contrary, the basis for markups *should* be sensitive to the changes in attributable costs incurred by a subclass and to changes in institutional costs. As shown during the cross-examination of Mr. Andrew, the effects of the Chown proposal change in a predictable manner when systemwide institutional costs change, when identifiable institutional costs change, and when attributable costs change.<sup>22</sup> That is why it is more accurate and equitable than the outmoded current approach. This is not “unstable”; it is simply better.

**2. Weighted attributable costs would not change the way institutional costs are assigned to Revenue Foregone preferred subclasses**

Ms. Chown’s proposed weighted attributable costs would not change the current method of determining the institutional cost contribution of subclasses that are preferred under the Revenue Foregone Act. As today, those subclasses would receive a percentage markup based on the percentage markup over actual (unweighted) attributable costs of the most closely corresponding regular subclass

Under the Revenue Foregone Act, a preferred subclass is to pay an institutional cost contribution measured as a percentage of the markup of the most closely corresponding regular rate subclass. In particular, the Act requires the preferred subclass’s applicable percentage markup to be calculated as the product derived by multiplying the percentage markup for the corresponding regular subclass relative to the “estimated costs attributable to such category of mail” times the appropriate phase-in. 39 U.S.C. §3626(a)(3)(B)(i). This requires that the preferred subclass’s markup be the

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<sup>22</sup> See Tr. 36/19790 & 19799 (Andrew).

appropriate fraction of the markup of the regular subclass calculated with actual (not "weighted") estimated attributable costs. The preferred subclass's markup would then be applied to the actual (unweighted) attributable costs of the preferred subclass.

The Commission should not be misled by the rebuttal testimony of USPS witness Taufique, who seems to have misunderstood Ms. Chown's proposal. Witness Taufique is simply wrong in asserting that the Chown proposal would add the Revenue Foregone determined institutional cost contribution to weighted attributable costs. This is particularly preposterous because (1) institutional cost contributions would not be added to weighted attributable costs even for commercial subclasses (Ms. Chown has never proposed to add the contribution to weighted attributable costs for any subclass); and (2) it ignores that Ms. Chown herself testified regarding the application of her proposal to the Revenue Foregone subclasses. Tr. 25/13338, 13345, & 13388-89 (Chown). Witness Taufique's rebuttal testimony deserves no weight.

**B. The Commission Also Should Place Greater Emphasis on Unit Contributions as a Principal Measure of Institutional Cost Contributions**

The Commission also should place a renewed and greater emphasis on relative unit contributions in assessing whether a certain class or subclass is contributing its fair share of institutional costs. Unit institutional cost contributions provide a straightforward means of comparing the fairness and equity of the institutional cost burden borne by different subclasses. This is a particularly useful measure for comparing subclasses with similar characteristics, such as some parts of First Class and the Standard (A) subclasses.



In past rate cases, the Commission has recognized that unit contributions are a useful tool to measure relative institutional cost burdens:

“Cost coverage is not the only measure of relative burden examined by the Commission. Unit, or per piece contribution, . . . is also a useful comparative measure . . . and it has been used to track relative changes in contribution between letter classes (first and third) . . . .”

*R87-1 Op.* at 370, ¶ 4038. Similarly, the Commission has employed unit contributions to ensure that discounted workshared categories do not avoid contributing to institutional costs:

“This record has reconfirmed the Commission's long-held view that *workshare discounts should reflect the costs that the Postal Service avoids by worksharing, so that the category makes the same per-piece contribution to institutional costs that it would have made had it not undergone worksharing.*”

*MC95-1 Op.* at IV-96, ¶ 4212.<sup>23</sup> In these decisions, the Commission has rejected the notion that cost coverages are necessarily determinative, and has relied significantly on unit cost contributions (applying the theory of Efficient Component Pricing) in setting discount passthroughs that send correct economic signals. *Id.* at III-27-29, ¶¶ 3069-74.

Examining unit contributions is useful and should be used for two reasons. First, unit cost contribution comparisons allow the Commission to consider directly the impact, in dollars and cents, of the non-cost factors, and can help identify where pieces

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<sup>23</sup> This approach received support in this case from the rebuttal testimony of USPS witness Panzar. In discussing what he referred to as “Efficient Discount Policy,” Professor Panzar observes that to implement such a discount policy the Commission would need only “set equal *absolute* mark-ups for the subclasses in question.” Tr. 34/18458 (emphasis in original). On cross-examination, he stated that by “equal absolute mark-ups” he meant the same contribution as measured in dollars and cents, not percentages. Tr. 34/18466-67.

of mail in different subclasses are failing to make a fair contribution to overhead. This is a particularly apt comparison for subclasses of relatively similar cost and operational characteristics, such as some parts of First Class and Standard (A) mail.

Second, unit cost contributions could usefully facilitate the Postal Service's expressed desire in this proceeding to avert unwanted "crossovers." Indeed, the desire to avoid certain "cross-overs" -- such as between ECR basic and Standard Regular 5-digit mail -- led the USPS pricing witnesses in this case to propose highly unusual rate design passthroughs in order to avoid undesirable consequences. By looking at the unit contributions made by pieces in the "cross-over rate categories" at issue, the Commission could ensure that the differences between the rates in each category reflected actual cost differences. This would set the proper cost signals.

Despite the Commission's recent attention to unit contributions as an effective tool to gauge equitable contribution levels, the Postal Service did not employ unit contributions in determining rate levels under its new costing method. Tr. 2/189 (O'Hara). *The Commission should not make the same error.*

**C. This Case Presents The Commission With Specific, Workable Proposals To Alleviate The Institutional Cost Burden On First Class Mail By Shifting Costs To Standard (A) Mail**

*The record contains several sound proposals for reducing the institutional cost burden now borne by First Class mail. The Commission should take the first step towards moving institutional cost burdens in the proper direction and adopt these proposals.*

**1. Dr. Clifton Has Proposed A Realistic, Timely, And Achievable Reduction In The Institutional Cost Burden Of First Class Mail**

NAA co-sponsored with the American Bankers Association testimony by Dr. James Clifton proposing to reduce the extra ounce rate for the second and third ounces of workshared First Class mail from the current (and proposed) 23 cents to a more equitable, but still high, 12 cents. Tr. 21/10815-89 (Clifton). Dr. Clifton proposes that the Commission recover the difference in revenue from Standard (A) mail. The net result would be to reduce the institutional cost burden on First Class mail by nearly \$200 million.

Dr. Clifton's testimony presents the cost and equity rationales for reducing the rate for the first and second extra ounces of First Class mail. In particular, he makes the following basic points:

1. That an excessive discrepancy exists between the institutional cost burdens borne by First Class and Standard (A) mail, as reflected in the 920 percent cost coverage of First Class workshared extra ounce mail;
2. That the current extra ounce charge of 23 cents for the first and second extra ounces of workshared First Class mail cannot be cost-justified, since the incremental cost of such mail is merely 2.5 cents;
3. That reducing the rate for these extra ounces to 12 cents is accordingly a very conservative proposal;
4. That the lack of an incremental ounce charge for the second and third ounces of Standard (A) letter mail is not cost-justified and could amount to an apparent cross-subsidy from First Class mail via institutional cost assignments; and
5. That the small revenue decrease due to the reduction of extra ounce rates for workshared First Class mail to 12 cents should be offset by raising the average cost coverage of Standard (A) mail by 2.8 percentage points.

Dr. Clifton observes that an extra-ounce business letter would pay, under the Postal Service's proposal, 23 cents per additional ounce if sent at First Class rates but

0 cents for the incremental weight if sent at Standard (A) mail rates. Tr. 21/10823.

Given the similarities in handling (indeed, they are often DPS sequenced together), this huge disparity creates a gaping equity issue. Tr. 21/10824 (Clifton). The inequity of the USPS proposal grows when one considers that an average First Class letter already pays 18 cents of institutional cost per piece, compared to the 7.9 cents of unit contribution paid by an average Standard (A) letter. Tr. 21/10824; *see supra* at III(B). Under the USPS proposal, a 3 ounce First Class 3-digit automation letter would pay 72.5 cents, while its Standard (A) counterpart would pay 17.8 cents.

Furthermore, Dr. Clifton's testimony demonstrates that the current First Class extra ounce rates paid by workshared mail cannot be justified on the basis of costs.<sup>24</sup> Therefore, Dr. Clifton calculates – in great detail -- that the incremental cost for the first and second extra ounces of First Class mail is 2.5 cents. Tr. 21/10831.<sup>25</sup> Given that the proposed incremental charge for this mail is 23 cents, Dr. Clifton observes that this amounts to an implied cost coverage for this mail of **920 percent**. Tr. 21/10831. The USPS has made no attempt to justify this extraordinarily high coverage and, indeed, it cannot.

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<sup>24</sup> Tr. 21/10827. The USPS in this case has provided no direct data on the incremental costs of First Class mail. Tr. 21/11175 (Bentley); Tr. 21/10827 (Clifton); Tr. 4/1438-46 (O'Hara).

<sup>25</sup> This estimate is quite reasonable. First Class workshared letters weighing 1 to 3 ounces run on the same automation equipment, and the USPS has found that the cost of processing the heavier letters is no more than for the lighter ones. Tr. 21/11175 (Bentley). Furthermore, USPS witness Hatfield assumed identical labor productivities within First Class mail. Tr. 21/11175 (Bentley).

To rectify this gross problem, Dr. Clifton proposes to reduce the extra ounce charge for the first and second additional ounces of First Class mail to 12 cents. Tr. 21/10831. Noting that such a rate would still produce an implied cost coverage for this mail of 480 percent, Dr. Clifton justifiably regards his 12 cent proposal as “very conservative.” Tr. 21/10832. Dr. Clifton’s specific proposal is limited to workshared mail, for which more cost data were available, but his testimony does not oppose broader relief. Tr. 21/11042. Indeed, the Commission reasonably could extend some reduction to single piece extra ounce rates as well. See Tr. 21/11173 (Bentley).

Dr. Clifton’s extra ounce proposal would reduce revenues from First Class workshared mail by \$138 million. Tr. 21/10832. To offset this reduction, he proposes to raise the Standard (A) cost coverage by 2.8 percent above the USPS’s proposal. Tr. 21/10833. NAA supports this proposal, which could be spread on an across-the-board basis, as a first step towards restoring the proper balance in the relative institutional cost burdens.

**2. Other proposals are also commendable**

**a. Dr. Clifton’s complementary proposal for automation discounts**

Dr. Clifton, in testimony co-sponsored by the American Bankers Association, Edison Electric Institute, and National Association of Presort Mailers, also proposes to enlarge the discounts for workshared First Class mail and reduce the cost coverage of that mail. That testimony demonstrates that “on grounds of economic efficiency and equity, the cost coverage proposed by the Postal Service” is too high for workshared First Class mail and proposes a more equitable cost coverage while raising the

coverage for Standard (A) mail. This testimony is entirely compatible with his ABA/NAA-T-1 testimony.

Dr. Clifton presented the combined effects of his proposals in Appendix C of ABA/NAA-T-1. If combined, his proposals would raise revenues for Standard (A) commercial mail by about \$575 million, without taking into account non-profit mail, while reducing First Class rates by \$1.1 billion. Tr. 21/10871 (Clifton).

#### **b. Proposals to retain the 32 cent stamp**

Both the OCA on brief and Major Mailers Association witness Richard Bentley have proposed to retain the 32 cent stamp. NAA believes that such an action could constitute a significant step in ameliorating the current imbalance in the institutional cost burden, but only if institutional costs are reallocated away from First Class mail. In this regard, NAA urges the Commission to be mindful of its limited jurisdiction over the revenue requirement.

### **3. The Commission should protect First Class mail**

Other factors also strongly support shifting institutional costs to Standard mail. Most importantly, such a shift would be fully consistent with the Commission's statutory mission to protect First Class mailers from excessive rates. As the Senate Report on the Act stated:

"The temptation to resolve the financial problems of the Post Office by charging the lion's share of all operational costs to first class is strong: that's where the big money is. The necessity for preventing that imposition upon the only class of mail which the general public uses is one of the reasons why the Postal Rate Commission should be independent of operating management."

S. REP. NO. 91-912, at 13 (1970). Consistent with this directive, the Commission should, in setting rates, focus on protecting First Class ratepayers, not on encouraging USPS competition with the private sector or its favoring one part of private enterprise over others.

Further, such an assignment of institutional costs could constitute a first step towards deterring the diversion of First Class mail to technological alternatives. Record evidence suggests that such threats to First Class mail might be significant. Professor Tolley's estimates of First Class volume took electronic alternatives into account in this case. While one cannot speak with absolute certainty on the effect that holding the line on First Class rates could have on deterring migration to electronic mail, the Postal Service might be at substantial risk if nothing is done to reduce the excessive institutional cost burden from First Class mail.

**V. RATE DESIGN ISSUES: THE COMMISSION SHOULD REFRAIN FROM MAKING CHANGES IN STANDARD (A) ENHANCED CARRIER ROUTE DISCOUNTS THAT ARE UNSUPPORTED BY THE RECORD**

**A. The Postal Service's Proposal To Increase Discounts For Different Presort Tiers In ECR Mail Is Unsupported**

In this proceeding, the Postal Service proposes dramatic increases in presort (or density) discounts for commercial ECR saturation and high density mail:

	Existing Cumulative Discount from Basic (cents)	Proposed Cumulative Discount from Basic (cents)	Percentage Change
<b>Letters</b>			
High-Density	0.8	2.1	+162.5%
Saturation	1.7	3.0	+76.5%
<b>Non-Letters</b>			
High-Density	0.8	1.1	+37.5%
Saturation	1.8	2.3	+27.8%

Tr. 27/14672 (Donlan). As the above table shows, the presort discounts for commercial ECR high-density letters would increase 162.5 percent and ECR saturation letter discounts would increase over 76 percent, while ECR non-letter discounts would increase 37.5 percent and 27.8 percent for high-density and saturation, respectively.

The Postal Service's proposed ECR presort discounts, however, rely on mail processing cost information that does not reflect current postal operating conditions and a faulty costing methodology that significantly overstates presort-related in-office delivery cost savings. As pointed out by NAA witness Donlan (NAA-T-2), the Commission should not increase these ECR discounts on the basis of inadequate and flawed data. Tr. 27/14680. Therefore, NAA urges that the Commission recommend no change in the Standard (A) Commercial ECR presort discounts at this time.



**1. The Postal Service's Underlying Standard (A) ECR Cost Calculations Do Not Reflect Current Postal Operating Conditions**

The Postal Service proposes for the first time to base commercial ECR presort cost discounts on *both* in-office delivery and mail processing cost differences between ECR presort tiers. Previously, mail processing costs were assumed to be the same for the different presort tiers, and presort discounts were based, therefore, only upon delivery cost differences. Tr. 27/14673 (Donlan). In this proceeding, the Postal Service purports to calculate the differences in mail processing costs in Library Reference H-109 (later filed as Exhibit 44A of USPS-ST-44) for the different presort tiers. However, the USPS's calculations of the mail processing cost differences across the different tiers are largely based on base year data collected prior to mail reclassification that overstate the cost difference between walk-sequenced and non walk-sequenced commercial ECR mail.

As the Commission is well aware, new preparation and entry requirements for commercial ECR letters and non-letters went into effect on July 1, 1996, near the end of the Postal Service's base year data period. Indeed, 10½ of the Postal Service's 13 base year accounting periods were pre-reclassification periods. Tr. 27/14677 (Donlan). Thus, about 80 percent of the data upon which the Postal Service bases its proposed ECR presort discounts reflect out-dated operating conditions and entry requirements.<sup>26</sup>

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<sup>26</sup> Mr. Donlan demonstrates that the reported cost difference between walk-sequenced (high-density and saturation) and non walk-sequenced (basic presort) non-letters has decreased dramatically following reclassification. The reported unit cost difference between walk-sequenced and non-walk-sequenced ECR non-letter mail decreased 32 percent from 2.2 cents/piece to 1.5 cents/piece. Tr. 27/14678 (Donlan). As postal workers become more proficient with the new requirements, this reported cost  
(Continued...)

The remaining 20 percent of the data -- a mere 2½ Accounting Periods during which the new mailing requirements were being implemented -- are inadequate to support the proposed increase in commercial ECR presort discounts.

Notably, the Postal Service offered no rebuttal to Mr. Donlan's testimony. Only ADVO witness Crowder attempted to rebut Mr. Donlan: "If witness Donlan's post-reclass data are reliable enough to refute the USPS estimated cost differences, they should be reliable enough to re-estimate those cost differences and reduce test year cost levels." Tr. 34/18336-7. However, neither Mr. Donlan nor NAA advocates new ECR discount levels based upon the 2 1/2 accounting periods of post-reclassification data.<sup>27</sup> To the contrary, Mr. Donlan's testimony points out that the data on which the Postal Service bases its proposed ECR discounts are inadequate and unreliable and that none of the data should be relied upon to change discounts. Ms. Crowder concedes that if FY97 data had been presented in this proceeding, such data could have provided the Commission better cost information on which to base presort discount levels. Tr. 34/18392.

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(...Continued)

difference likely would decrease further. Tr. 15/7763-64 (McGrane).

<sup>27</sup> Witness Crowder is simply incorrect when she asserts that if the data are "reliable" enough to illustrate a problem in the data, then the data are "reliable" enough to use to compute cost differences. The data clearly show an inconsistency between the pre-reclassification and post-reclassification periods. This illustration does not imply that any of the data are sufficiently reliable or adequate to support the proposed discounts.

**2. The Postal Service overstates ECR presort cost savings by failing to account for cost savings arising from operational changes**

In addition to the inadequate mail processing cost data, other methodological problems greatly overstate the presort-related in-office delivery cost savings. USPS witness Hume computes the delivery costs for the different tiers of ECR mail based upon an analysis performed in Docket No. R90-1 by Postal Service witness Shipe.<sup>28</sup> See Tr. 34/18393-4. However, those productivities were calculated under very different operating conditions.<sup>29</sup> Failure to reflect these different operating conditions greatly overstates the in-office delivery cost differences among the presort tiers for both non-letters and letters.<sup>30</sup>

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<sup>28</sup> In Docket No. R94-1, the Commission expressed its displeasure at not having updated analyses of cost differences for establishing discounts.

"The Commission believes the cost studies used in Docket No. R90-1 are no longer reliable because of the operational changes that have taken place and because of changes in how mailers prepare mail."

*R94-1 Op.* at V-99, ¶ 5306. The Postal Service has not updated its study of the in-office delivery cost differences for ECR mail since Docket No. R90-1. It continues to rely on the out-dated productivities from this study.

<sup>29</sup> Mr. Shipe computed his productivities prior to (1) the introduction of vertical flat cases, (2) the use of automated equipment to delivery point sequence letters, and (3) the adoption of new preparation requirements that all carrier-route mail be, at a minimum, line-of-travel sequenced.

<sup>30</sup> ADVO rebuttal witness Crowder contends that the in-office delivery cost differences alone are sufficient to justify the Postal Service's proposed increase in the ECR non-letter presort discounts. Tr. 34/18337. However, as demonstrated below, these differences are overstated for both ECR letters and non-letters.

**a. The in-office delivery cost savings for non-letters and letters fail to reflect the requirement that all ECR mail be, at a minimum, line-of-travel sequenced**

USPS witness Hume computes the cost differences for the ECR presort tiers using the productivities calculated in Docket No. R90-1 for in-office delivery costs. However, these productivities overstate the cost differences between ECR high-density/saturation and ECR basic mail since *all* ECR mail is now required to be entered in line-of-travel sequence or walk-sequenced. Tr. 15/7760 (McGrane).

In Docket No. R90-1, USPS witness Shipe computed the in-office casing productivities for letters and flats that were sequenced and non-sequenced.<sup>31</sup> Therefore, witness Hume's use of the non-sequenced productivities for ECR basic letters and non-letters in this case likewise assumes that this mail is not sequenced.<sup>32</sup> However, the preparation and entry requirements introduced after reclassification now require ECR basic mail to be, at a minimum, line-of-travel sequenced.

Accordingly, one might have expected Mr. Hume to make use of productivities calculated by Mr. Shipe in Docket No. R90-1 for mail which is segment/sector

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<sup>31</sup> These productivities showed that walk-sequenced letters and flats were cased at more than twice the speed as non-sequenced mail. See Docket No. R90-1, Exhibit USPS-10B, at 1. Walk-sequenced letters were cased at a rate of 41.2 pieces per minute compared to 20.6 pieces per minute for non-sequenced letters. Walk-sequenced flats were cased at a rate of 27.4 pieces per minute compared to 13.2 pieces per minute for non-sequenced flats.

<sup>32</sup> Hume computes cost differences of approximately 1.5 cents per piece for basic letters and 2.4 cents for basic flats when compared to saturation letters and flats. Exhibit USPS-18B, at 6. These computations were based on Mr. Shipe's corresponding productivities from Docket No. R90-1: unit cost differences of approximately 1.4 and 2.3 cents per piece for basic letters and flats respectively, when compared to saturation walk-sequenced letters and flats. Docket No. R90-1, USPS-10B, at 1.

sequenced and street sequenced.<sup>33</sup> These productivities should better reflect the relative casing speed for ECR basic letters and flats, given the required line-of-travel sequencing, and not surprisingly were greater than the productivities used by witness Hume for ECR basic mail. The use of these higher productivities for basic mail would have greatly reduced the cost differences between the tiers. But Mr. Hume **does not use these more relevant productivities**, and therefore overstates the cost savings for sequencing.

**b. The in-office delivery cost differences for letters are overstated due to the delivery point sequencing of many ECR basic letters**

In addition to misusing the underlying productivity data, the USPS overstates significantly the cost difference between ECR commercial basic letters and high-density/saturation letters by not taking into account the reductions in carrier in-office delivery costs that have occurred as a result of delivery point sequencing. While the Postal Service attributes the additional mail processing costs associated with DPS processing for ECR letters, it fails to subtract the corresponding cost savings in city carrier in-office delivery costs.

Delivery point sequencing is used to "sort the mail directly to delivery point, avoiding the in-office workhours required for the carrier to sort this mail manually." *MC95-1 Op.* at IV-21, ¶ 4056. The USPS has made a concerted effort to capture bundles of ECR basic letters, and barcode these letters for incorporation into the

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<sup>33</sup> These sequencing methods are similar to line-of-travel sequencing. These productivities were 25 to 35 percent higher for both flats (Docket No. R90-1, Exhibit USPS-10B, at 4) and letters (Docket No. R90-1, Exhibit USPS-10B, at 6).

carriers' DPS mail, thereby eliminating the in-office carrier delivery costs associated with manual casing of ECR basic letters. USPS-T-4 at 8 (Moden). USPS witnesses Daniel and Moeller developed worksharing discounts based upon witness McGrane's mail processing cost data and witness Hume's delivery cost data. Witness McGrane developed mail processing cost data which captured the additional mail processing costs incurred as a result of the Postal Service barcoding ECR basic letters for DPS.

However, the Postal Service concedes that it has not offset the increased mail processing time for applying barcodes to ECR Basic letter mail with a reduction in city carrier in-office time. Tr. 15/7680-1 (McGrane). Neither witness Hume (nor any other Postal Service witness) accounts for the corresponding delivery cost savings that resulted from eliminating the manual casing of ECR basic letters. Tr. 15/7771-2 (McGrane). Therefore, the Postal Service cost estimates admittedly *overstate* the actual cost difference between basic and high-density/saturation letter mail.

The USPS submitted no rebuttal testimony to defend or correct the overstatement of in-office delivery cost differences. The only rebuttal witness that attempted to defend the Postal Service's erroneous cost differences was ADVO witness Crowder. She asserts that all automation-related delivery cost savings are already accounted for in USPS base-year delivery cost data and therefore, implicitly included in witness Hume's ECR letter delivery cost analysis. Tr. 34/18338-9. While it is true that the *average* base year costs for ECR letter mail may implicitly include these cost savings, discounts are based upon *cost differences* -- not *average* base year letter costs. Tr. 34/18402. It is these cost differences, based *solely* upon differences in Mr.

Shipe's R90-1 productivities, that fail to reflect the costs savings associated with DPS processing of letters.

Consider the case where both an ECR basic letter mailing and an ECR saturation letter mailing are DPS processed. As witness Crowder admits, the in-office delivery cost differences for these two mailings are zero. Tr. 34/18410-1. If instead the ECR basic letter mailing were DPS processed but the ECR saturation letter mailing were not, then the saturation mailing would incur in-office delivery costs that the ECR basic letter mailing does not. Tr. 34/18411-2. This example illustrates that the in-office *delivery cost differences between basic letters and saturation letters could indeed be less than zero.*<sup>34</sup>

The USPS estimate of the in-office delivery cost difference between basic and saturation letters is 1.5 cents per piece and its estimated mail processing cost difference is 1.6 cents per piece, for a total of 3.1 cents. Exhibit USPS-29C, at 2, revised 10/1/97. The Postal Service proposes to passthrough almost this entire 3.1 cents total in its presort discount of 3.0 cents for saturation letters, compared to the current discount of 1.7 cents. Given that the actual in-office delivery cost differences between these two tiers could well be zero (or negative), the current discount should be maintained.

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<sup>34</sup> Given the Postal Service's concerted effort to "identify and capture" ECR basic letter mail for DPS processing, the percentage of ECR basic letters that are DPS processed likely exceeds the percentage of high-density and saturation letters that are DPS processed. Hence, many ECR basic letters will have lower in-office delivery costs compared to high-density/saturation letters.

**3. The Commission should recommend no change in the presort differential at this time**

As demonstrated above, the proposed presort discounts are based upon inadequate and outdated data. Also, the Postal Service's own witness admits that the cost data include the added mail processing costs of DPS processing, but fail to reflect the lower in-office delivery costs that result from this processing. Due to these deficiencies, the Commission should recommend no change in the current discounts at this time.

**B. The Commission Should Reject AMMA Witness Andrew's Proposal To Increase Destination Entry Discounts For Standard (A) Mail**

The Postal Service proposes to set destination entry discounts for Standard (A) Mail equal to 80 percent of the estimated cost avoided. The 80 percent passthrough maintains the discounts at current levels and, according to USPS witness Moeller, *these proposed discounts will "continue to encourage mailer dropshipment."* USPS-T-36 at 30. Mr. Moeller also contends that "a greater passthrough would require a larger increase in the basic rates" and that a larger increase in the basic rates would conflict with "efforts to mitigate substantial increases for individual rate categories." USPS-T-36 at 30. Mr. Moeller also states that the 80 percent passthrough "should allay the concerns of parties who contend that setting the discount for all minimum-per-piece rated pieces by using a weight of 3.3 ounces 'over-rewards' destination entry." Tr. 6/2897.

In contrast, AMMA witness Andrew (AMMA-T-2) proposes destination entry discounts for Standard (A) Mail based upon 100 percent passthrough of the cost savings. Tr. 20/10129. Mr. Andrew contends that less than 100 percent passthrough



sends a false price signal to the market and will fail to "maximize productive efficiency." Tr. 20/10136. According to his calculations, his proposed 100 percent passthrough will result in increases in the ECR basic piece rate of 0.5 cents for both letters and non-letter mail. Tr. 20/10138. NAA believes that the discounts proposed by Mr. Andrew are excessive for mail pieces weighing less than the breakpoint and will result in an unwarranted offsetting rate increase for ECR basic letters.

The continuity of the existing minimum per piece/per pound rate structure for Standard (A) mail requires setting the dropship discount for "below breakpoint" pieces at equal to the discount for the pound rated pieces multiplied by 3.3 ounces divided by 16 ounces (that is, per piece discount = per pound discount x 3.3 ounces/16 ounces). In effect, each dropshipped piece of mail entered at the minimum piece rate receives a destination entry discount equal to the discount for a piece of mail weighing 3.3 ounces. Yet, the average weight of ECR letters is only 1.02 ounces and the average weight of ECR non-letter mail below the breakpoint is only 2.01 ounces.<sup>35</sup> Tr. 6/2812 (Moeller).

The Commission recognized in Docket No. R90-1 that the discounts will be overstated for mail below the breakpoint if the cost savings are weight related. *R90-1 Op.* at V-266, ¶ 6000. In that case, the Commission concluded that the cost savings may not be entirely weight related and ultimately recommended destination entry discounts equal to approximately 80 percent of the cost savings. *Id.* at V-279, ¶ 6024. However, the Commission expressed concern regarding the "absence of a definitive

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<sup>35</sup> Almost three quarters of ECR mail are letters and non-letters weighing less than the breakpoint. See Moeller's workpapers at 20. Therefore, establishing an appropriate cost based discount for minimum piece rate mail is as critical or more critical than establishing the correct discount for the pound rated mail.

study expressly addressing the effect of lightweight pieces on entry-related (and other) costs..." *Id.* at V-265, ¶ 5999. The Commission cautioned that it would be "reluctant to consider more extensive recognition without a study that address the methodological concerns raised on this record." *Id.* at V-288, ¶ 6040.

Eight years later, the Postal Service still has not produced any study, let alone a definitive study, on this issue. Nor has Mr. Andrew. There continues to be no further fundamental study of the cost savings associated with destination entry of lightweight pieces of mail. However, as shown in Library Reference H-111, avoided transportation costs account for 80 to 85 percent of the estimated dropship savings.<sup>36</sup> Attributable transportation costs vary according to the volume (cubic feet) of the mail which is proportional to the weight of the mail. Therefore, the bulk of the dropship cost savings are indeed likely to be weight related.

If the dropship savings were entirely weight related, then an average ECR letter (weighing 1.02 ounces) would give rise to cost savings of approximately **0.9** cents if dropshipped to the DDU (13.79 cents per pound x 1.02 ounces divided by 16 ounces). This savings compares to the much larger destination entry discounts of **2.3** cents per piece proposed by the Postal Service and **2.8** cents per piece as proposed by AMMA witness Andrew. Tr. 20/10137. This 0.9 cents estimate of cost savings *may* be

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<sup>36</sup> Library Reference H-111, page 2 shows total dropship savings for Standard (A) mail of 9.04 cents per pound for mail entered at the destination BMC, 11.05 cents per pound for mail entered at the destination SCF and 13.79 cents per pound for mail entered at the DDU. These total dropship savings include both transportation and non-transportation related savings. Transportation savings amount to 7.69 cents per pound, 9.06 cents per pound and 11.08 cents per pound for mail entered at the DBMC, DSCF and DDU, respectively.

somewhat understated *if* the non-transportation cost savings (approximately 20 percent of the total savings) are not weight related. However, even if the cost savings were 25 or 50 percent higher, neither the Postal Service's nor witness Andrew's proposed destination entry discounts for ECR letters are cost justified.

Similarly, the estimated cost savings for an average ECR non-letter below the breakpoint (weighing 2.01 ounces) would be 1.73 cents if entered at the DDU. If these cost savings are understated by 33 percent, then the Postal Service's proposed discount of 2.3 cents per piece might be cost-justified ( $1.73 \text{ cents} \times 1.33 = 2.3 \text{ cents}$ ).

However, in order for witness Andrew to justify *his* proposed discount of 2.8 cents per piece, the cost savings would have to be understated by over **60** percent. There is no evidence that the cost savings are understated by that magnitude. On the contrary, Mr. Andrew concedes that the cost savings below the breakpoint are unknown. Tr. 20/10151.

Therefore, there is no support for witness Andrew's position that the proposed discounts fail to "maximize productive efficiency."<sup>37</sup> The available evidence suggests that the current destination entry discounts for mail pieces below the breakpoint are too *high*, rather than too *low*. If anything, the record evidence on cost savings supports a *decrease* rather than an *increase* in destination entry discounts for mail pieces below the breakpoint.

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<sup>37</sup> The current cost savings suggest that the mailers are already performing work that can be more efficiently performed by the Postal Service. Therefore, it would be inefficient to increase the discounts, thereby providing additional incentive to the mailers to transport their own mail at greater cost.

Most of the Postal Service's proposed destination entry discounts equal the current discounts.<sup>38</sup> While NAA is not proposing to reduce these discounts, it strongly opposes making them larger. Expansion of these discounts would make them less cost-based for the three-quarters of ECR mail weighing less than the breakpoint.

The Commission should also bear in mind that witness Andrew's proposed *destination entry discounts would necessitate an increase in the ECR basic letter rate* by an additional 0.5 cents per piece over the increase proposed by the Postal Service. This additional increase would single out ECR basic letters for an increase of 12.7 percent when compared to current rates – without taking into account the consequences of any other ratemaking decisions.

For the foregoing reasons, NAA urges the Commission to reject AMMA's proposal to expand these discounts based on a 100 percent passthrough of the cost savings.

**C. The Commission Should Pass-Through A Greater Amount Of The Cost Difference Between Letters and Flats Consistent With Achieving The Postal Service's Automation Goals**

NAA has consistently supported responsible efforts to reduce Postal Service costs, especially those that comport with the USPS's public service mission by promising benefits to First Class mailers. The automation program is an example of such an effort. NAA has also consistently supported the recognition of shape-based cost differences in rates, which were first introduced in third-class mail in Docket No.

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<sup>38</sup> The proposed destination entry discounts for piece-rated pieces are equal to current discounts for DSCF and DDU mail. For pieces entered at the destination BMC, the Postal Service proposes a small increase from 1.3 to 1.5 cents per piece.

R90-1. The Commission has determined that “not recognizing the letter-flat cost difference when there is evidence of a significant difference is not fair and equitable under the pricing criteria.” *Docket No. MC95-1 Op.* at V-256, ¶5647.

In this case, however, the Postal Service has cited an offsetting rationale for ECR basic letters that presents a conflict between the laudable goals of promoting the automation program and recognizing the cost differences between letters and flats. As explained by Mr. Moeller, the USPS has a strong operationally-driven goal of encouraging Standard (A) carrier-route presort letters to be mailed as Standard (A) Regular subclass automation letters, rather than as Standard (A) ECR basic letters. USPS-T-36 at 27-28. To create a rate incentive for this to occur, due to the potential for basic carrier-route letters to “cross-over” between the Standard (A) ECR and Regular subclasses, the ECR Basic letter rate should exceed (if only barely) the Standard Regular 5-digit automation letter rate. USPS-T-36 at 27. To achieve this, Mr. Moeller found it necessary not to recognize a letter/flat rate distinction at the Basic ECR tier, lest the ECR basic letter rate fall below the Standard Regular 5-digit automation rate. USPS-T-36 at 28.

NAA believes that Mr. Moeller’s proposal at the Basic ECR level, while inconsistent with a principled recognition of shape-based differences, is an acceptable accommodation in this case. Therefore, if, after making other cost and rate decisions, the Commission finds that a zero passthrough of letter/flat cost differences is still necessary in order to recommend an ECR basic letter rate higher than the Regular 5-digit rate, it should recommend adoption of Mr. Moeller’s proposal.

However, the rationale for ignoring such shape-based differences does not apply at higher ECR tiers, as the USPS has no plan to routinely process high-density and saturation letters on barcode sorters. Accordingly, the Commission should continue to recognize the cost difference between letters and flats at the high-density and saturation tiers. The Commission should passthrough the cost differences between letters and flats at the ECR high-density and saturation tiers to the maximum extent possible, moving towards a full 100 passthrough of the cost differences between letters and flats.

## **VI. ATTRIBUTABLE COST ISSUES**

The Commission has, over time, approved methodologies for attributing costs in the various cost segments. These approved attribution methodologies, as improved by certain refinements in this case as described in this Section, provide the most reliable measure in this case of attributable costs.

Major Mailers Association witness Richard Bentley and OCA witness Thompson have presented estimates of the Postal Service's costs using the Commission's established cost attribution methodologies. With the modifications suggested in this section, these methodologies provide a sound basis for attribution.

NAA notes that the Postal Service has filed testimony by witness Takis which purports to provide estimates of incremental costs. See USPS-T-41. Mr. Takis's testimony is not, in actuality, a true analysis of incremental costs. That is because it makes no attempt to estimate costs in a redesigned operational environment that results from the assumed disappearance of a class of mail. Rather, it is a cost presentation that accommodates the effects of alleged economies of scale in the

USPS's proposed costing methodologies. As such, it comes closer to approximating the Commission's definition of "attributable cost" -- including the attribution of single subclass stop access and load costs -- than the USPS's "volume variable" presentations.

It is also important to note that Mr. Takis's testimony does not, in reality, attempt to conduct the kind of cross-subsidy analysis that is necessary where a facility or cost is shared by two or more subclasses. Nor does Mr. Takis develop an accurate measure of incremental costs for Standard mail as a whole class. These would include, for example, not only the single subclass stop costs for the Standard mail subclasses, but also for those multiple subclass stops at which only Standard mail is delivered.<sup>39</sup> NAA continues to believe that a serious, systematic analysis of access costs for multiple subclass stops is warranted.

**A. The Commission Should Continue To Attribute City Carrier Access And Load Time Costs On The Basis Of Single Subclass Stops**

Since Docket No. R90-1, the Commission has consistently attributed Cost Segment 7 city carrier access costs on the basis of what has come to be known as the

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<sup>39</sup> Section 3622(b)(3) speaks of "classes" of mail, not subclasses, so examining cost attribution only at the subclass level is not, strictly speaking, what the Act contemplates. Nor is it consistent with protecting mailers from cross-subsidization, as a single *class* stop methodology would offer more protection than the single *subclass* approach. Currently, if a stop is accessed to deliver a piece of Standard ECR and a piece of Standard Regular mail, the access cost nonetheless is treated as institutional -- and thus paid by First Class mail. The Commission can group access costs incurred by a single class of mail as readily as those incurred by a single subclass. To prevent cross-subsidization across classes, one class must not pay for costs incurred by other classes or groups of classes. Those costs should be paid only by those classes that cause the costs.

"single subclass stop" methodology.<sup>40</sup> The Commission has attributed coverage-related load time on this basis as well. The Commission should reapply its single subclass stop methodology in this case.

*The only exception from this consistent line of decisions occurred in Docket No. MC95-1, where the Commission did not use the single subclass stop methodology to attribute costs to the reclassified subclasses due solely to the lack of information regarding accesses by reclassified subclasses. MC95-1 Op. at IV-55 to IV-60, ¶¶ 4132-4144. However, the Commission made clear that its action in that case was for one-time only due to the lack of necessary data. MC95-1 Op. at IV-60, ¶ 4144 (emphasis added). The Postal Service has presented no new evidence that would warrant the Commission departing from its preferred single subclass stop attribution.*<sup>41</sup>

Although the Postal Service's direct case uses its volume variability approach to estimate test year city carrier access costs, the Postal Service also provides the single subclass stop information in the testimony of witness Takis. See USPS-T-41; Tr.

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<sup>40</sup> See R87-1 Op. at 269, ¶ 3427; R90-1 Op. at III-57, ¶ 3124; *Opinion and Recommended Decision on Remand*, Docket No. R90-1 at 55, ¶ 370; R94-1 Op. at III-44, ¶ 3147. The Commission has done so mindful of its statutory obligation to "attribute to subclasses all costs that can be reliably associated with them, regardless of economic theory, primarily for reasons of inter-class equity." R90-1 Op. on Remand at 41, ¶ 334 citing *National Association of Greeting Card Publishers v. United States Postal Service*, 462 U.S. 810, 828 (1983); see also R94-1 Op. at III-41-42, ¶¶ 3136-3142.

<sup>41</sup> The theoretical testimony of Dr. Panzar (USPS-T-12) on the uses of marginal and incremental costing essentially repeated his testimony from previous dockets. However, the Commission has previously determined that such theoretical economic approaches, however interesting, are not consistent with the Congressional intent that "attributable costs . . . provide a floor upon which the rate was to be built." *Docket No. R94-1 Op. on Remand* at 54, ¶ 368.



9/4711 (Takis). In particular, the single subclass stop ratios needed were entered into the record at Tr. 9/4779-4781 (document filed as LR-H-184 "Documentation of Single Subclass Ratios" and electronic versions of Mr. Takis's workpapers).<sup>42</sup>

The Postal Service's submission of these data reflects its acknowledgment that single subclass costs are in fact caused by the particular subclass delivered at that stop<sup>43</sup> (even though the USPS still takes the position that such costs should be used only to apply the "incremental cost" test – see USPS Trial Brief at 22). The USPS continues to argue, however, that such costs should not be considered "attributable" or used in setting the base to which institutional cost contributions are added. The USPS is incorrect; the Commission has squarely addressed this issue in a series of past decisions, and the matter should now be considered settled. See VII(A), *infra*.

Accordingly, the Commission should continue to attribute city carrier access costs using its single subclass stop methodology. As in the past, this methodology should also apply to coverage-related load costs. USPS witness Baron has agreed that such costs could be treated in the same manner as access costs generally. Tr. 29/16163-64.<sup>44</sup>

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<sup>42</sup> Witness Takis testifies that his single subclass stop cost ratios are reasonable, given his view that few "fixed" costs are truly fixed. Tr. 9/4721.

<sup>43</sup> Tr. 9/4711 (Takis) (stating that "single subclass stop costs are clearly incremental to individual subclasses").

<sup>44</sup> Testifying on behalf of ADVO, DMA, AMMA, MOAA, and PSA, witness Crowder disagreed, in an interrogatory response, that coverage-related load costs could be attributed on the basis of single subclass stop. Tr. 29/16233-42. This argument was not in her testimony. Her answer is quite complex and, on this record, has not received sufficient analysis to justify a departure from the Commission's precedent.

**B. The Commission Should Reject USPS Witness Bradley's Proposal To Reduce The Level Of Attributed Mail Processing Costs**

In this proceeding, the Postal Service has introduced a new analysis of the volume variability of mail processing costs. Postal Service witness Bradley (USPS-T-14) submitted an econometric analysis comparing the total piece handlings to the total workhours for each mail processing activity. Prior to this analysis, it was assumed that mail processing direct labor costs were proportional to volume.

Relying on this analysis, the Postal Service proposes to reduce the level of attribution of mail processing costs. This reduction is particularly evident in manual operations. The Commission must now decide whether this analysis accurately captures the causal relationship between mail pieces and the mail processing costs and whether the resulting lower attribution levels should be adopted.

NAA leaves it to other parties to debate the merits of the model specification (for example, whether to use a "fixed effects" or "random effects" specification) and the appropriateness of the independent and dependent variables employed in the model. Instead, NAA has examined the proposed reduction in attribution from a practical point of view.

Setting aside all the technical and theoretical debates on the model, *the crux of the issue is the existence or absence of economies of scale*. If there exist economies of scale in the mail processing activities, mail processing labor hours (and hence, costs) are not proportional to volume and are not 100 percent volume variable. However, if there are no economies of scale in the mail processing activities, then mail processing labor costs are 100 percent volume variable and should continue to be attributed on this basis.

NAA believes that the Postal Service has failed to demonstrate that there exist economies of scale in either machine-based or manual operations in the long run. Therefore, the Commission should reject the Postal Service's revised analysis, and continue to attribute mail processing costs as in the past, in the manner referred to as the "100 percent volume variable" methodology.

**1. Machine-based operations do not experience long-run economies of scale**

In machine-based operations, Professor Bradley contends that economies of scale exist since there are fixed functions performed within the activity, such as machine set-up time, that do not vary with volume. USPS-T-14 at 55-6. Also, Professor Bradley states that economies of scale can exist if increased specialization increases productivities. USPS-T-14 at 56. For example, a large volume of mail processed on barcode sorters will allow workers to become familiar with the machine and process this mail more efficiently. Finally, Professor Bradley mentions that certain gateway activities such as facing and canceling or optical character reading may exhibit economies of scale since these operations "must be up and running and ready to receive mail as it comes into the stream." USPS-T-14 at 57.

The first two explanations for possible economies of scale -- the fixed machine set-up time and increased specialization leading to improved productivities -- exist only in the short run and therefore, do not demonstrate economies of scale over the longer run. First, the amount of machine set-up time is a direct function of the number of machines used to process the mail. And, in turn, the number of machines used to process the mail is a direct function of the volume of mail processed. Tr. 11/5346

(Bradley). Therefore, it is only in the short-term, when the number of machines is fixed, that machine-based mail processing activities will demonstrate economies of scale due to the non-volume variable nature of the set-up time.<sup>45</sup>

Second, productivity increases as workers gain experience with the equipment. However, these productivity gains are also short-lived. Postal Service operations witness Moden describes the adjustment period that occurs when automated equipment is installed at a facility. USPS-T-4 at 20-21. Mr. Moden states that "[t]he adjustment period can delay achievement of the optimal productivity." *Id.* at 21. Witness Moden states that Professor Bradley should have excluded data from these time periods in order to accurately measure the economies of scale that exist after workers have become accustomed to the equipment. Tr. 6/5851. Nonetheless, Professor Bradley included data from these periods of adjustment in his analysis.<sup>46</sup> Therefore, it is not surprising that Professor Bradley's analysis appears to show

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<sup>45</sup> Witness Bradley admits that "technically speaking" his measures of variability are short-run because "the Postal Service does not have complete flexibility to adjust all its inputs in the time horizon I'm thinking of." Tr. 11/5524. Also, his research did not analyze the relationship of mail processing costs and volumes across all processing options. Tr. 11/5340. Had he analyzed the cost of mail processing across all operations, his results could have shown diseconomies of scale in the short run. For example, if there were inadequate machine capacity to process mail in the short run, the USPS would rely on manual operations to process any additional volumes. The higher cost of the manual sorting would yield a marginal cost that is higher than the average cost in the short run, indicating diseconomies of scale. Tr. 34/18270-71 (Christensen).

<sup>46</sup> Professor Bradley excluded data from an activity until the size of the operation exceeded 100,000 piece-handlings per accounting period. Tr. 11/5355. However, it takes only one or two accounting periods to reach this threshold level once a machine has been accepted from the manufacturer. Tr. 11/5356. Thus, Professor Bradley does not exclude sufficient data to avoid capturing the learning curve effects during the adjustment period described by witness Moden.

economies of scale. However, there are no studies which indicate that productivity gains will continue after the adjustment period.<sup>47</sup>

Finally, the premise that some machine-based activities will be subject to economies of scale due their "gateway" nature suggests that workers are idle or are not working at full speed in these activities while they are waiting for mail to arrive. This statement suggests that there is a surplus of available labor at these activities -- a suggestion contradicted by the Postal Service's own operations witness, Mr. Moden: "a manager generally has adequate flexibility to size the workforce to the workload" and the Postal Service can "match staff to workload using casuals, transitional [e]mployees, overtime, etc." Tr. 11/5768 & 5796. Furthermore, Mr. Moden states that gateway activities are "generally staffed to meet the expected volume" and "employees can be shifted to meet unexpected volumes." Tr. 11/5856.<sup>48</sup> Thus, there is no evidence that a surplus of labor exists on an on-going basis that would give rise to continuing economies of scale.

For the above reasons, the Postal Service has failed to demonstrate that there exist any long-run economies of scale in machine-based operations. Therefore, the Commission should continue to attribute mail processing costs for these operations assuming 100 percent volume variability.

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<sup>47</sup> There are no studies that indicate that increased volumes of mail improve mail processing productivity, absent technological changes. Tr. 11/5347.

<sup>48</sup> Witness Moden does admit that gateway activities have an increased risk of *momentary* idleness caused by insufficient mail. Tr. 11/5856. However, given the flexibility of staffing available to a manager, this momentary idleness cannot be expected to persist over the long run. Tr. 11/6050.

**2. Manual operations also do not experience long-run economies of scale**

According to Professor Bradley, the greatest economies of scale exist in manual operations. Witness Moden contends that these economies of scale exist because clerks in manual operations work at a greater speed when a steadier flow of mail is present. Tr. 11/5852. If this reasoning is correct, then these economies of scale exist only if workers are idle or inefficient during periods of low volume, leading to excess labor in manual operations, or if these workers can step up the pace *indefinitely* during volume surges. There is no evidence that either condition exists.

The Postal Service vehemently denies that excess labor exists in manual operations. Witness Moden denies that manual cases are staffed prior to the "late surges" in volume but instead states that "[s]upervisors plan for staff to ramp-up coincident with a ramp-up in volume, or slightly later than the ramp-up to avoid instances when employees momentarily run out of mail to process." Tr. 11/5852. Further, Mr. Moden states that manual parcel employees are "assigned to other operations temporarily . . . ." Tr. 11/5854. He also explains that the USPS does not staff manual operations with excess labor in case of eventualities such as machine breakdowns or insufficient capacity on automated equipment but instead "[w]e staff to workload. Work rules provide sufficient flexibility to match the work force to the work load in manual cases." Tr. 11/5931-2. All of these statements deny the existence of excess labor in manual operations.

Therefore, the only possible remaining explanation for economies of scale in manual operations is that people simply work faster when there is more mail to process.

Based upon the Postal Service's observations, this may be true for short periods of time. However, before the Commission attributes costs on the basis of this argument, it should be convinced that this faster pace is sustainable as volume continues to increase. *If the faster pace is not sustainable, then the marginal costs will return to the level of the average cost.*<sup>49</sup> On this point, Professor Bradley admits:

"In the short run, it is possible that an increase in volume could be handled by a temporary but unsustainable increase in productivity. . . . Because such levels of effort are not sustainable, productivity would return to its regular value, and a sustained increase in volume would require the Postal Service to add more labor."

Tr. 11/5512. There is no evidence that workers can continue to work at a high pace in the presence of ever-increasing volumes.

For these reasons, the Postal Service has failed to demonstrate the existence of sustainable economies of scale in manual operations. Given this failure, the Commission should continue to attribute costs assuming 100 percent volume variability of costs in these manual operations.

**C. Witness Nelson's Attribution Of Some Park-And-Loop Costs By Weight Should Be Adopted**

USPS witness Nelson introduced in this proceeding a new analysis of carrier drive time park-and-loop variability based upon actual drive and stop field data. No party rebutted Mr. Nelson's analysis and NAA urges the Commission to adopt it.

In Docket No. R90-1, the Commission was troubled by the lack of data on the volume variability of parking stops (and hence overall drive time), and adopted then-

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<sup>49</sup> See also the testimony of UPS Witness Neels. Tr. 28/15625-6.

UPS witness Nelson's proposed 50 percent volume variability for park-and-loop drive time costs as an "interim estimate." *R90-1 Op.* at III-92, ¶ 3201. The Commission requested that "additional analytic work be performed by the next general rate proceeding." *Id.* Although it has taken an extra rate proceeding, that additional analysis has been performed and is described by witness Nelson. See USPS-T-19. In particular, Mr. Nelson's Motorized Letter Route Survey is an important improvement over existing methodology that should be adopted because the Commission would no longer need to rely on mere theoretical analysis or rough estimates to calculate park-and-loop drive time volume variability, but could rely on actual park-and-loop drive data.

**D. USPS Witness Wade's Attribution Of Vehicle Service Driver Costs Should Be Adopted**

USPS witness Wade proposes a volume variability estimate for Cost Segment 8 vehicle service driver ("VSD") operations. USPS-T-20 at 21. No party offered any critique of this analysis. The Commission should accept his estimate because it represents a major step forward in a VSD cost estimation process that has relied excessively on assumptions instead of actual data.

In previous rate cases, variability estimates for VSD operations have been based on assumptions that load time was the only VSD factor affected by volume, and that VSD operation variability was similar to, or the same as, that of intra-SCF highway contract routes. *Tr.* 7/3215. In this docket, however, the Postal Service finally has attempted to directly measure VSD volume variability by analyzing data specifically from VSD operations. *Tr.* 7/3217.



While witness Wade acknowledges that some "improvements in data and methodology are always possible," his VSD data collection and analysis, nevertheless, improve on prior methodologies. NAA urges the Commission to adopt the analysis.

## **VII. PRICING ISSUES**

### **A. Institutional Costs Should Be Marked Up From All Attributable Costs, Not Merely Volume Variable Costs**

Despite consistent precedent to the contrary, the Postal Service proposes to base institutional cost determinations on volume variable costs, rather than all costs caused by the various subclasses. As it has in the past, the Commission must reject such a proposal as being contrary to the Postal Reorganization Act. Simply put, the Act requires that the Commission attribute to a class (or subclass) all costs caused by that class (or subclass), and that these attributable costs must serve as a floor for institutional cost markup.

#### **1. The Commission has long construed Section 3622(b)(3) to require the basis for marking up institutional costs to be all attributable costs, not merely volume variable costs**

Section 3622(b)(3) of the Act provides that the Postal Rate Commission shall recommend changes in rates and fees in accordance with:

"the requirement that each class of mail or type of mail service bear the direct and indirect postal costs attributable to that class or type plus that portion of all other costs of the Postal Service reasonably assignable to such class or type."

39 U.S.C. § 3622(b)(3). The Commission has, repeatedly, addressed the issue of the proper floor for institutional cost markups finding in every case that the institutional cost markup should be applied to *all* attributable costs. Nevertheless, the Postal Service proposal that the institutional cost markup should be applied only to volume-variable

costs is yet again before this Commission. See USPS Trial Brief at 33. And yet again, this proposal must be rejected.

The Commission has consistently interpreted Section 3622(b)(3) as requiring it to add institutional cost assignments to a rate floor of attributable costs, not merely volume variable costs. The Commission's interpretation is correct, and should not be disturbed.

In Docket No. R94-1, the Commission determined that "[b]ecause causation in an unrestricted sense is the basis for attribution under section 3622(b)(3), *any* costs (not just "marginal" costs) reliably shown to be incurred by users of one subclass of mail must be included in the attributable cost floor for that subclass in order to carry out the overriding statutory purpose that such costs not be borne by users of another subclass." *R94-1 Op.* at III-42, ¶ 3139 (emphasis in original). Further, on remand in Docket No. R90-1, the Commission likewise determined that "[s]ection 3622(b)(3) requires that all costs causally related to a subclass serve as a rate floor to which a judgmentally determined share of institutional costs are to be added." *R90-1 Remand Op.* at 54, ¶ 369 (citing *NAGCP*, 462 U.S. at 833).

Perhaps the Commission's clearest explanation was set forth in Docket No. R87-1, when it rejected the same Postal Service proposal:

"Congress expected the floor to be constructed for each class and the rate built upon it. The opposite procedure, in which a rate is arrived at by marking up marginal (not incremental or attributable) cost and only in suspicious cases checked for consistency with a cost floor not theretofore constructed, *seems to us the opposite of what the Act contemplates*. In a great many cases there is no necessary inconsistency between the results these two processes are capable of achieving; but we think it clear that Congress wanted the job done in a particular way, rather

than simply wanting rates pretty certainly equal to or greater than incremental cost."

*R87-1 Op.* at 103, ¶ 3009 (emphasis supplied).<sup>50</sup> These decisions apply with equal force today, and compel rejection of the USPS proposal that the Commission apply the institutional cost markups to volume variable (or marginal) costs.<sup>51</sup>

## 2. The Postal Service's arguments for basing institutional costs on volume variable costs are not consistent with the Act

Despite this consistent line of contrary precedent, the Postal Service proposes once again to markup volume variable costs. The main support for this proposal is Professor Panzar's economic testimony. Professor Panzar argues, as he has in previous cases, that marking up volume variable (or short run marginal) costs rather than attributable (or incremental) costs increases economic efficiency. USPS-T-11 at 28.<sup>52</sup> However, his testimony – which was also rebutted by UPS witness Henderson -- is neither consistent with the Act nor persuasive.

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<sup>50</sup> In that discussion, the Commission specifically recognized that the "relation between incremental cost [as described in Docket No. R87-1] and the class it is associated with thus appears to be the same relation as 'attributability' under the Act." *R87-1 Op.* at 101, ¶ 3007.

<sup>51</sup> As a matter of ratemaking policy, applying markups to only the volume variable costs would be undesirable because it would blur the concept of recovering institutional costs. Section 3622(b)(3) requires that the rates for each class of mail both cover that class's attributable costs, as well as contribute to the recovery of the institutional costs. Yet, assessing cost coverages on volume variable costs would, in effect, relieve a class from having to pay for both its full amount of attributable costs that it clearly causes *and* its assigned portion of institutional costs, a result which would be neither fair nor equitable nor consistent with Section 3622(b).

<sup>52</sup> He also advocates the use of incremental costs to evaluate postal rates for cross-subsidy. *Id.* at 8-11.

First, Professor Panzar acknowledged that he was testifying solely on the basis of economics and did not intend the Commission to rely on his testimony to set markup levels. Tr. 9/4665. He also acknowledged that he did not consider the Act's non-economic factors, factors that the Commission must consider. Tr. 9/4657; USPS-T-11 at 8. *Neither did he consult prior Commission decisions.* Tr. 9/4656. Thus, the Panzar testimony is little other than an interesting intellectual exercise.

Second, the Panzar testimony is inconsistent with the Act because Congress emphasized many factors other than economic efficiency.<sup>53</sup> As USPS witness O'Hara acknowledges, economic efficiency conflicts with many of the Act's factors. *See e.g.,* Tr. 2/209-211.

Third, witness Panzar's economic theory does not even ensure social economic efficiency. The fact that one has to set rates at something other than marginal cost at all means by definition that the resulting rates are not economically efficient. Tr. 25/13325 & 13399 (Chown). And Professor Panzar admits that prices that are economically efficient from the Postal Service's perspective might not be economically efficient from society's perspective. Tr. 9/4671 & Tr. 9/4680. UPS witness Henderson demonstrated that postal prices based on short-run marginal costs would need to change frequently in order to achieve economic efficiency. Tr. 25/13559.<sup>54</sup> Thus, not

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<sup>53</sup> See, e.g., Sections 3622 (b)(1), (4), (7), and (8).

<sup>54</sup> UPS witness Henderson also observed that the use of incremental costs to check for cross-subsidy may encourage inefficient entry into the respective market unless incremental costs are marked up. UPS-T-3 at 10-11.

only is the Postal Service's economic efficiency unsound as a legal matter, it is unsound as an economic matter as well.

**B. The Commission Should Place No Weight On Ramsey Pricing Estimates**

**1. Ramsey pricing is incompatible with the Postal Reorganization Act**

The Postal Service and the OCA present testimony on Ramsey pricing. As described further below, the testimonies of both USPS witness Bernstein and OCA witness Sherman are hopelessly flawed and cannot be relied upon to set postal rates. However, the Commission need not even reach the issue of the credibility of the testimony of witnesses Bernstein and Sherman because it, as confirmed by the Second Circuit, has already determined that Ramsey pricing is incompatible with the Postal Reorganization Act.

In Docket No. R84-1, DMA presented testimony that the Commission is required by the Act to use Ramsey pricing, or the "inverse elasticity rule," in assigning institutional costs. *Direct Marketing Ass'n, Inc. v. U.S. Postal Service*, 778 F.2d 96, 103 (2<sup>nd</sup> Cir. 1985). That testimony was rejected by both the Commission and the Second Circuit. As that Court found:

"We disagree with the [DMA] argument that Congress intended relative demand to be the benchmark for the assignment of institutional costs. Rather, it is clear that no single factor was intended by Congress to be the 'primary' factor in making the assignments. . . . Moreover, we agree with the Postal Service that DMA's approach [of Ramsey pricing] places unwarranted emphasis on relative demand for postal services."

*Id.* at 103-104.

Thus, the core of the problem with Ramsey pricing is that it relies exclusively on only one of the Act's factors - - relative demand - - to the exclusion of other factors. Indeed, as AAPS witness Bradstreet observes, Ramsey pricing is tantamount to "tossing nearly the entire ratemaking criteria section out of the Postal Reorganization Act," (Tr. 23/12005), despite the fact that Congress included those criteria in the Act in order to restrain the Postal Service from abusing its monopoly status through predatory pricing. Tr. 23/11996-98. Dr. Clifton also points out that Ramsey pricing would tend to abuse, not protect, monopoly ratepayers on the grounds that it would tend to legitimize "monopoly pricing" while the goal of "postal rate regulation is to replicate efficient *competitive prices in rate design insofar as possible.*" Tr. 25/12691 (*emphasis in original*).

NAA does not urge the Commission to ignore relative demand in setting rates. However, the Commission should, and must, balance that factor *with all other factors* in setting rates that are consistent with the Act. Therefore, the Commission once again must reject Ramsey pricing.

## **2. The technical presentations of Ramsey pricing are inconsistent and hopelessly flawed**

Even if the Commission were inclined to ignore all the other factors in the Act and to adopt some form of Ramsey pricing, neither Bernstein nor Sherman has presented the Commission with an appropriate set of Ramsey prices. Both Bernstein and Sherman rely on Postal Service estimates of own-price and cross-price elasticities. These elasticities were not developed for the purpose of deriving Ramsey prices, but instead were developed as an input into the volume forecasting process. These

elasticities are neither sufficiently precise nor accurate to be used to derive Ramsey prices.

In fact, many cross-price elasticities are assumed to be zero even in the face of common sense and contradictory evidence. For example, both Bernstein and Sherman assume that there is zero cross-price elasticity of demand between Standard (A) Regular mail and Standard (A) ECR mail.<sup>55</sup> If there is zero cross-price elasticity between these two closely-related subclasses, then why, according to the Postal Service's own estimates, are 3.3 billion pieces of letter mail expected to migrate from Standard (A) ECR mail to Standard (A) Regular mail on the basis of *price*? USPS-T-36 at 28. Such migration demonstrates that a significant positive cross-price elasticity exists between these two subclasses of mail.<sup>56</sup>

Including the appropriate cross-price elasticities in the Ramsey pricing models would greatly change the results. If there are cross-price elasticities between the Standard (A) Regular and ECR subclasses, then the Ramsey prices for both Standard (A) Regular and Standard (A) ECR mail would have been higher.<sup>57</sup> Tr. 26/13791

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<sup>55</sup> OCA witness Sherman relies on the Postal Service's estimates of zero cross-price elasticity between these two subclasses. However, he further states that "[I]f two subclasses of mail offered services so similar in quality and price that one was a good substitute for the other, it would be reasonable to expect a positive cross elasticity between them." Tr. 26/13788.

<sup>56</sup> Both Mr. Bernstein and Professor Sherman ignore all cross-price elasticities with private sector alternatives; thereby greatly overstating the loss of consumer welfare that results from rates that deviate from Ramsey prices.

<sup>57</sup> Witness Bernstein explains that the existence of a positive cross-price elasticity makes raising the price of the lower-priced product "an effective way of raising net revenue." USPS-T-31 at 63. For this reason, a positive cross-price elasticity between Standard (A) Regular and Standard (A) ECR will make raising the price of Standard (A) (Continued...)

(Sherman). The existence of private sector alternatives would also lead to increases in the Ramsey prices for those subclasses with available alternatives., Tr. 10/5072 (Bernstein); Tr. 26/13782-3 (Sherman). Hence, ignoring these cross-price elasticities leads to an understatement in the Ramsey prices for subclasses of mail with competitive alternatives to the detriment of those subclasses of mail with no alternatives.

### **VIII. CONCLUSION**

For the foregoing reasons, the Newspaper Association of America respectfully urges the Postal Rate Commission to recommend rates in a manner consistent with this Initial Brief, NAA's Trial Brief, and NAA's Memorandum of Law on the Pound Rate for Standard (A) Enhanced Carrier Route Mail, and with due recognition that the Postal Service is a "basic and fundamental service" provided to the American public by the federal government on a non-discriminatory basis, and not a competitively motivated

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(...Continued)  
ECR an effective way of raising net revenue.




entity free to favor selected mailers in competitive private markets with preferential rates.

Respectfully submitted,

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#### CERTIFICATE OF SERVICE

I hereby certify that I have this date served the instant document on all participants of record in this proceeding in accordance with section 12 of the Rules of Practice.

April 1, 1998

  
William B. Baker